

***United States Court of Appeals  
for the Second Circuit***



**BRIEF FOR  
APPELLEE**





# 77-7082

To be argued by  
BARTLETT H. MCGUIRE

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IN THE  
**United States Court of Appeals**  
FOR THE SECOND CIRCUIT

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BRITTA DANIELS as Trustee of the Testamentary Trust  
under the Will of HENRY DANIELS, deceased, and  
BRITTA DANIELS, individually,

*Plaintiff-Appellant,*

—against—

ERNST & ERNST,

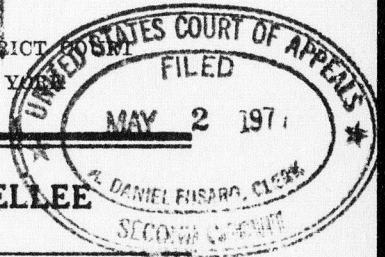
*Defendant-Appellee.*

ON APPEAL FROM THE UNITED STATES DISTRICT  
FOR THE SOUTHERN DISTRICT OF NEW YORK

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**BRIEF FOR DEFENDANT-APPELLEE**

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IN THE

# **United States Court of Appeals**

**For the Second Circuit**

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No. 77-7082

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BRITTA DANIELS as Trustee of the Testamentary Trust  
under the Will of HENRY DANIELS, deceased, and BRITTA  
DANIELS, individually,

*Plaintiff-Appellant,*

—against—

ERNST & ERNST,

*Defendant-Appellee.*

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ON APPEAL FROM THE UNITED STATES DISTRICT COURT  
FOR THE SOUTHERN DISTRICT OF NEW YORK

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## **BRIEF FOR DEFENDANT-APPELLEE**

This brief is filed on behalf of defendant-appellee Ernst & Ernst in support of the decision of Hon. Marvin E. Frankel, of the United States District Court for the Southern District of New York, granting Ernst & Ernst's motion for summary judgment based on the running of the statute of limitations. CCH Fed. Sec. L. Rep. ¶ 95,871 (S.D.N.Y. 1977).

### **Statement of the Issue**

Did the District Court properly find that the three-year statute of limitations had run as to alleged misrepresentations concerning the financial condition of Beck Industries,



Inc. ("Beck") where, more than three years prior to the filing of this action:

a. plaintiff had actual knowledge—including a 90% decline in the price of Beck's stock, a ten-month suspension of trading and the filing by Beck of a petition under Chapter X of the federal bankruptcy laws—sufficient to make a prudent person suspect that misrepresentations may have been made; and

b. plaintiff's husband told her that he had been "taken" and that the financial condition of Beck had been misrepresented to him?

### **Statement of the Case**

#### **A. Nature of the Case and Proceedings Below**

This case was brought on April 15, 1975 by the widow and successor in interest of Henry Daniels, the former sole shareholder of Pomett Manufacturing Company d/b/a Hartogs of California and Swirts Inc. d/b/a Hartogs Inc. (collectively referred to as "Hartogs"). Mrs. Daniels seeks to recoup, from Ernst & Ernst, losses which allegedly resulted from her husband's entering into what turned out to be a disadvantageous business deal—the sale of Hartogs to Beck in 1969. The sale involved an exchange of the Hartogs stock for Beck stock which became virtually worthless by May 1971, when Beck filed a petition under Chapter X of the federal bankruptcy laws.

Mrs. Daniels alleges that Ernst & Ernst misled her husband and his accountants, and violated SEC Rule 10b-5, by negligently and recklessly auditing Beck financial statements which misrepresented the company to be in sound financial condition. Plaintiff also asserts pendent state-law

claims based upon the same facts but framed in terms of, among other things, fraud, gross negligence and breach of contract with Beck.

On the basis of the complaint, the deposition of Mrs. Daniels and two affidavits—one made by Newton Glekel, former chairman of Beck—Ernst & Ernst moved for summary judgment on statute of limitations grounds. Finding that the three-year statute applicable to plaintiff's federal claim had commenced running no later than May 1971, Judge Frankel held that the present action, filed in April 1975, was time-barred.\*

#### **B. Summary of Ernst & Ernst's Position**

Plaintiff's federal claim is governed by California's three-year statute of limitations for fraud. The statute begins to run when the claimant—here, plaintiff or her husband, to whose claim she is successor—had suspicions, or had knowledge sufficient to put a prudent person on notice, that misrepresentations may have been made which constituted securities fraud.

The undisputed facts are that by April 15, 1972—three years before the present complaint was filed—the following events had occurred with respect to Beck (further detail is supplied in the Statement of Facts):

1. From February 1969 to July 1970, the price of Beck's stock fell from \$42.50 to \$4.50 on the American Stock Exchange.
2. Following the collapse of a proposed underwriting of debentures, Beck requested and was granted, on July 10,

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\* The pendent state-law claims were dismissed as a result of Judge Frankel's ruling, at this preliminary stage of the litigation, that the federal claim was time-barred (348a). Plaintiff does not suggest that the pendent claims should survive the dismissal of the federal claim.



1970, a suspension of trading in its common stock on the American Stock Exchange. Trading was never resumed.

3. Between July 1970 and May 1971, Beck met with its banks and debentureholders to delay the maturity of its obligations and to seek additional financing; replaced its entire top management team; and sold off a number of subsidiaries in order to improve its cash position. The public press regularly referred to Beck's "financial crisis".

4. In August 1970, two of Beck's subsidiaries filed petitions under Chapter XI of the federal bankruptcy laws.

5. In September 1970 and April 1971, suits were brought against Beck, and/or its officers and directors, claiming misrepresentations as to Beck's financial condition. These suits were reported in the public press.

6. On May 27, 1971, Beck filed a petition for reorganization under Chapter X of the federal bankruptcy laws.

7. According to Mrs. Daniels' testimony, both she and Mr. Daniels were aware, in July 1970, that Beck stock had dropped from over 40 to under 5. They learned, in July 1970, of the suspension of trading in Beck stock. They also learned, in May 1971, of Beck's petition under Chapter X of the bankruptcy laws.

8. In both July 1970 and May 1971, Mr. Daniels advised his wife that the financial condition of Beck had been misrepresented to him. She understood that the alleged misrepresentations extended to the financial statements. As Mr. Daniels said to his wife, "I really was taken."

Under established case law in this and other Circuits, the above occurrences are more than ample to set the statute of limitations in motion as to Ernst & Ernst. Plaintiff and her husband both had actual and constructive knowl-

edge of many facts that should have aroused their suspicions as to the alleged misrepresentations here. Further, Mrs. Daniels has testified that they did in fact believe, as early as 1970 and 1971, that misrepresentations had been made which extended to Beck's financial condition and to its financial statements. Nevertheless, neither plaintiff nor her husband brought any action relating to the financial condition or financial statements of Beck until the present action was filed in April 1975—well beyond the three-year period of limitations.\*

### Statement of Facts

#### A. The Complaint

The heart of this action is ¶ 10 of the Second Amended Complaint (the "Complaint"). There, plaintiff alleges that, during the course of negotiations which culminated in Mr. Daniels' sale of Hartogs to Beck in 1969:

"various representations were made to the plaintiff's decedent and to his accountant, CLARENCE RAINS [*sic*], by BECK INDUSTRIES INC. and its accountants, the defendant, ERNST & ERNST. Said representations concerned the financial condition of BECK INDUSTRIES INC. and these representations were made to the plaintiff's decedent by the defendant and by BECK INDUSTRIES INC., with the intent that the plaintiff's decedent and his agents rely thereon. These repre-

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\* Ernst & Ernst has denied the ultimate conclusion which plaintiff draws from the facts summarized above—*i.e.*, that the financial statements were in fact misrepresented. Such a denial is entirely consistent with Ernst & Ernst's statute of limitations defense. By pointing out facts which were sufficient to make a prudent man suspicious of possible misrepresentations, Ernst & Ernst in no way admits that any misrepresentations were in fact made or that it was negligent or reckless in failing to ferret out any such misrepresentations.

sentations, when made, were false and were known to the defendant, ERNST & ERNST and BECK INDUSTRIES INC. to be false when made. Specifically, these representations reflected BECK INDUSTRIES INC. to be a corporation in a sound financial condition whereas in fact, said corporation was not and indeed, as was known to the defendant, ERNST & ERNST, was in serious financial difficulties at the time" (24a).\*

The complaint further alleges that "Ernst & Ernst aided, abetted, actively participated in, and act[ed] in concert with Beck Industries, Inc." in perpetrating the alleged fraud (25a).

In short, Mrs. Daniels contends that Beck, with the aid of Ernst & Ernst, misrepresented to Mr. Daniels and his accountants that the company was in sound financial condition, whereas in fact it was in serious financial difficulties. She further contends that these alleged misrepresentations, which were made "[i]n 1969 and prior thereto" (24a), fraudulently induced Mr. Daniels to sell his business to Beck, and resulted in losses to Mr. Daniels which totaled several million dollars (30a, 31a).

## **B. The Parties**

### **1. Plaintiff**

Mrs. Britta Daniels is the widow and successor in interest of Henry Daniels (20a, 44a). Mr. and Mrs. Daniels were residents of California from 1966 until September 1973,

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\* Appendix citations are to the deposition, affidavits and pleadings herein, and to Ernst & Ernst's Statement Pursuant to General Rule 9(g) (44a-52a) which is based entirely on those materials. Under Rule 9(g) all material facts set forth in Ernst & Ernst's Statement are deemed admitted by the plaintiff, since she has not submitted any statement of her own which controverts any of the facts set forth by Ernst & Ernst.



when Mr. Daniels died. Mrs. Daniels has continued to live in California since that time (44a, 136a, 138a, 148a). Mr. Daniels' testamentary trust, which Mrs. Daniels represents as trustee, is also located in California (11a-12a, 44a, 144a).

## **2. Ernst & Ernst**

Ernst & Ernst is a partnership of independent accountants having offices in various states of the United States (20a, 35a, 45a). Ernst & Ernst conducted audits and examined and reported upon Beck's consolidated financial statements for the fiscal years 1968 and 1969 with certain exceptions noted in its reports thereon (23a, 37a, 45a).

## **C. The Sale of Hartogs in Exchange for Beck Stock**

In 1969, Mr. Daniels was the president and sole shareholder of Hartogs (45a, 139a-40a). Hartogs, made up of two California corporations located in downtown Los Angeles, was in the business of designing, manufacturing and selling shirts to retailers (45a, 139a-42a, 213a). A number of companies approached Mr. Daniels prior to 1969 with a view to purchasing Hartogs (153a-54a). During this time Mr. Daniels utilized the services of at least two securities brokers—one from Bache & Company and one from Blair Securities (150a-51a), the latter of whom was actually the finder for the sale of Hartogs to Beck (155a).

Negotiations with Beck began prior to Christmas 1968, at which time Mr. Daniels received a number of Beck annual reports (45a, 157a, 162a-63a). Mr. Daniels met on a number of occasions with Beck representatives, including Charles McDevitt, president of Beck, and Robert Fine (45a, 155a-56a). James Brown, the long-time lawyer for Mr. Daniels as well as Hartogs, participated in the negotiations on Mr. Daniels' behalf (45a, 142a-44a, 153a).



According to Mrs. Daniels, McDevitt and Fine told her husband that Beck was a "great company" and that Beck was in "a very sound financial condition" (46a, 157a-58a). Mr. Daniels was assured by Beck representatives that Beck stock could only go up (46a, 158a-59a). The Beck representatives also discussed Beck's plans to acquire more companies in the future and to build up Hartogs' business (46a, 158a, 161a).

On July 1, 1969, Beck and Mr. Daniels entered into an agreement for the sale by Mr. Daniels of all of Hartogs' stock to Beck, in exchange for \$4.2 million in Beck common stock (30a, 46a, 231a-32a). The agreement provided that the value of the Beck stock at the closing date was to be determined by adding \$5 to the average price of Beck stock on the American Stock Exchange for the five days preceding the closing (237a). Pursuant to this formula, Beck transferred 140,351 shares of common stock to Mr. Daniels at the closing, which took place on December 9, 1969 (275a-77a).\*

As part of the sale of Hartogs to Beck, Henry Daniels was given a five-year employment contract by Beck (46a, 159a, 267a-74a). Mr. Daniels remained as president of Hartogs until his death in 1973 (46a, 148a).

#### **D. Events After the Closing**

##### **1. *The Precipitous Drop in Price and the Suspension of Trading in Beck Stock***

From February 1969 to July 1970, Beck stock dropped from \$42.50 to \$4.50 on the American Stock Exchange (46a,

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\* Because Hartogs' performance for the full year 1969 fell below expectations, Beck later requested the return of 16,225 shares pursuant to a formula based on 1969 earnings (280a-81a). Mrs. Daniels was unsure at her deposition as to the exact amount of Beck stock which Mr. Daniels ultimately retained (170a). All of that stock is currently in trust for her son (170a-71a).

63a). On or about July 10, 1970, approximately seven months after the closing of the Hartogs acquisition, Beek asked the American Stock Exchange for a temporary suspension of trading in its stock, in order to protect its shareholders and prevent speculative trading after Beek learned that a hoped-for public debenture offering, to be underwritten by Weis, Voison, Cannon, Inc., was not going to proceed on schedule (47a, 62a). Consequently, on July 10, 1970, the American Stock Exchange suspended trading in Beek Common stock (47a, 63a). The Exchange never reinstated trading in Beek's stock (*ibid.*).

Beek's announcements regarding the failure of the debenture offering and the suspension of trading were sources of comment in the public press, including the Los Angeles *Times* (47a, 54a-55a, 56a-57a, 63a, 68a-69a).<sup>\*</sup> The Wall Street *Journal* referred to the situation as "a financial crisis" for Beek (68a).

**2. Mr. Daniels' Statement in 1970 that  
Beck's Financial Condition Had Been  
Misrepresented to Him**

Mr. and Mrs. Daniels knew contemporaneously that trading in Beck's stock had been suspended in July 1970 (174a) and that the price of Beck's stock had dropped from over \$40 in 1969 to under \$5 just prior to the suspension (47a-48a, 176a-77a). Upon learning of the suspension, Mr. Daniels told his wife that Beck's financial condition had been misrepresented to him (48a, 174a-75a). She understood that the alleged misrepresentations extended specifically to the financial statements which Mr. Daniels had received before signing the agreement to sell Hartogs (48a,

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<sup>\*</sup> Mrs. Daniels has testified that she maintained a subscription to the Los Angeles *Times* throughout the relevant time period (172a).

186a-87a). As Mr. Daniels put it, "I was taken. . . . I really was taken" (48a, 175a).

### **3. Beck's Attempts to Avoid Bankruptcy**

During the period from July 11, 1970 through May 1971, the Beck management took a number of actions in what Judge Frankel characterized as "an effort to avoid complete financial collapse" (343a). These actions were a source of continuing comment and publicity in the public press, which frequently referred to Beck's "financial crisis" or "financially troubled" condition (48a, 54a-55a, 56a-59a, 64a, 99a-118a). Basically, Beck's attempts to avoid bankruptcy fell into three categories:

a. Beck met with its banks and debentureholders on a number of occasions to delay the maturity of its obligations and to seek additional financing (48a, 56a, 64a, 99a-102a, 104a).

b. Beck attempted to improve its cash position by selling off a number of its newly-acquired subsidiaries (48a, 55a, 65a). Within two weeks after the debenture offering had fallen through, Beck announced the sale of its Watkins Furniture subsidiary. The *Wall Street Journal* quoted Beck's secretary and corporate counsel as saying that the subsidiary had been sold "principally to raise needed additional capital due to the current liquidity crisis" (102a; see also 59a).

Less than a month later, Beck revealed that it had sold Judy's, a California chain of women's apparel stores, back to the people it had acquired the company from in 1969 (105a-06a). At the same time, Beck announced that its 1969 acquisition of Romay of California had been cancelled (*ibid.*). And in September 1970, Beck made public the sale of yet another recently-acquired subsidiary—Disco-Fair, a



12-unit West Coast discount chain—back to Vornado, its original owner (107a-08a).

c. In addition, Beck undertook a wholesale management shakeup (49a, 65a). The first major move occurred shortly after the debenture offering had fallen through, when Charles McDevitt resigned as president and chief executive officer (55a, 58a, 65a, 100a-01a), and Newton Glekel became chairman and chief executive officer (*ibid.*). Less than two weeks later, Manuel Rothberg became president and a director, and replaced Glekel as chief executive officer (65a, 103a-04a).

In early September, three more Beck directors resigned and five new members were elected to an expanded board (65a, 109a, 110a, 113a). One of the directors who resigned at this time was Bertram Slater, who had been the financial vice-president. Continuing the management merry-go-round, Mr. Glekel resigned as chairman of the board and chairman of the executive committee in early October 1970 (65a, 114a-15a). Following Mr. Glekel's departure, Manuel Rothberg became chairman of the board and Herbert Engelhardt became president (65a, 117a-18a).

#### **4. *The Continuing Road to Bankruptcy***

Despite Beck's efforts to shore up its operations, its financial condition continued to deteriorate, a fact which was a source of repeated commentary in the public press (65a-66a, 119a-31a). In late August 1970, two of Beck's subsidiaries, H. Liebes & Co. and The Peddlers, Inc., filed for protection under Chapter XI of the federal bankruptcy laws (49a, 66a, 119a, 122a). The New York *Times* reported the Liebes bankruptcy as "[t]he first sizable business failure in the current, prolonged slump in retailing" (119a). Two days after the filing of the Liebes petition was announced, The New York *Times* had a feature article in

its Sunday business section entitled "At Beck: Acquisition Indigestion" (120a-21a). The article concluded that: "The reasons for the comings-and-goings of the executives and for the company's financial problems revolve around the acquisition syndrome—the frenzied drive to achieve instant growth and instant earnings by buying companies".\*

Beck's publicly-announced earnings for the first six months of its fiscal year 1970, and for the first 39 weeks, further indicated the unsoundness of Beck's financial condition. In October 1970, Beck announced that for the six months ended August 1, it had suffered a net loss of \$651,000 from continuing operations before extraordinary items, compared with earnings of \$533,000 a year earlier. The extraordinary items involved a net loss of \$19.7 million for the period (49a, 66a, 123a). In December 1970, Beck reported a net loss of \$1.6 million from continuing operations before extraordinary losses for the 39 weeks ended October 31, compared with earnings of \$1.4 million a year earlier. At the same time, Beck reported an extraordinary loss of \$18.5 million plus a net loss of \$1.6 million from discontinued operations (49a, 66a, 126a).

**5. *The 1970 and 1971 Lawsuits Alleging that Beck's Financial Condition Had Been Misrepresented***

In September 1970, the former shareholders of one subsidiary (A. K. Salz Tanner, Inc. ("Salz"), acquired by Beck in November 1969), sued Beck and a number of individuals and banks on the ground that Beck's financial condition had been misrepresented to them. The complaint alleged that

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\* One of plaintiff's allegations herein is that Ernst & Ernst "failed or refused to ascertain and reveal that it [Beck] was acquiring too many businesses in too short a time" (28a). This allegedly injudicious business practice was, however, a matter of public comment almost five years before the complaint was filed.

in negotiating the acquisition of Salz, Beck had overstated its assets, understated its liabilities, concealed its losses and misstated its working capital (50a-51a, 63a, 70a-86a).

Similar allegations concerning the misrepresentation of Beck's financial condition were included in an action filed in April 1971 by Harold Ross, a former member of the Beck board. Mr. Ross alleged that Messrs. Glekel and McDevitt had willfully misrepresented and concealed large losses, deteriorating sales and financial difficulties of Beck in 1969 and 1970, and that they had continuously presented incorrect information as to current operations, even when Beck had allegedly become insolvent (51a, 63a-64a, 88a-97a). Both the *Salz* and *Ross* actions were reported in the public press (51a, 87a, 98a).

#### **6. Beck's Chapter X Petition—May 27, 1971**

The denouement came on May 27, 1971 when Beck filed a petition for reorganization under Chapter X of the federal bankruptcy laws (50a, 55a, 61a, 66a-67a, 132a-33a). The *Los Angeles Times*, *New York Times* and *Wall Street Journal* all quoted Beck's president as stating, "After months of negotiation and intensive effort to resolve the company's serious financial difficulties, the company has concluded that the interests of its stockholders and creditors will best be served by utilizing the judicial procedures available under Chapter 10" (50a, 61a, 132a-33a).

#### **7. Mr. Daniels' Restatement, in 1971, that Beck's Financial Condition Had Been Misrepresented to Him**

After learning of Beck's Chapter X petition, Mr. and Mrs. Daniels had a discussion in May 1971 similar to the one they had had in July 1970. Mr. Daniels repeated that he had been taken and that Beck's financial condition had not been as good as it had been represented to him in 1969 (50a, 177a-79a).



## A R G U M E N T

### I.

**Plaintiff's Claims Are Time-Barred Because, Prior to April 15, 1972, She and Mr. Daniels Were on Notice as to the Alleged Misrepresentations.**

#### **A. Applicable Legal Principles**

Judge Frankel held, and plaintiff agrees, that pursuant to New York's borrowing statute the appropriate statute of limitations in this case is California's three-year statute for fraud, Cal. Code Civ. Proc. § 338 (344a; Pl. Br. at 2). *See Korn v. Merrill*, 403 F. Supp. 377, 382-86 (S.D.N.Y. 1975), *aff'd*, 538 F.2d 310 (2d Cir. 1976).

Plaintiff also accepts Judge Frankel's holding that the limitations period begins to run on "the date of the discovery of the fraud or [on] the date the fraud should upon reasonable inquiry have been discovered" (344a; Pl. Br. at 2-3). *See Berry Petroleum Co. v. Adams & Peck*, 518 F.2d 402, 410 (2d Cir. 1975); *Korn v. Merrill*, *supra*, 403 F. Supp. at 387. *See also Turner v. Lundquist*, 377 F.2d 44 (9th Cir. 1967), where the court upheld an order granting summary judgment and dismissing a securities fraud action as time-barred under the three-year California statute:

"[W]hen knowledge had by or imputed to plaintiff is such as to compel the conclusion that a prudent man would have suspected the fraud, the Court may determine as a matter of law that there had been 'discovery'." 377 F.2d at 47.\*

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\* Plaintiff contends that "... neither she nor her husband had the slightest suspicion of any wrongdoing by Ernst and Ernst until December, 1973. In effect, the court below has adversely passed upon the credibility of plaintiff in this regard which the Court had no right to do on this motion for summary judgment" (Pl. Br. at 12). Judge Frankel did nothing of the kind. In making this argument, plaintiff has simply ignored the principles set forth in the accompanying text.

In determining whether plaintiff should as a matter of law have discovered an alleged fraud, the courts have imposed an affirmative due diligence requirement. Thus, in *Hupp v. Gray*, 500 F.2d 993 (7th Cir. 1974), the Court of Appeals for the Seventh Circuit stated:

"It is well established that a plaintiff may not merely rely on his own unawareness of the facts or law to toll the statute. . . . The plaintiff, rather, has the burden of showing that he 'exercised reasonable care and diligence in seeking to learn the facts which would disclose fraud.' . . . The statutory period '[does] not await appellant's leisurely discovery of the full details of the alleged scheme.' *Klein v. Bower*, 421 F.2d 338, 343 (2d Cir. 1970)." 500 F.2d at 996. See also *Berry Petroleum Co. v. Adams & Peck*, *supra*, 518 F.2d at 410.

Applying these principles, the courts have repeatedly invoked the summary judgment procedure to dispose of cases filed long after plaintiff should have suspected the fraud alleged in his complaint. See, e.g., *Arneil v. Ramsey*, CCH Fed. Sec. L. Rep. ¶ 95,865 (2d Cir. 1977); *Berry Petroleum Co. v. Adams & Peck*, 518 F.2d 402 (2d Cir. 1975); *Winkelman v. Blyth & Co., Inc.*, 518 F.2d 530 (9th Cir.), *cert. denied*, 423 U.S. 929 (1975); *Hupp v. Gray*, 500 F.2d 993 (7th Cir. 1974); *Klein v. Bower*, 421 F.2d 338 (2d Cir. 1970); *Turner v. Lundquist*, 377 F.2d 44 (9th Cir. 1967); *Korn v. Merrill*, 403 F. Supp. 377 (S.D.N.Y. 1975), *aff'd*, 538 F.2d 310 (2d Cir. 1976); *Briskin v. Ernst & Ernst*, 398 F. Supp. 997 (C.D. Cal. 1975).

#### **B. Plaintiff Was Aware of Facts Sufficient to Make Further Inquiry Prudent**

While plaintiff "concedes that she and her husband were aware of Beck's financial disintegration in 1970 and 1971" (Pl. Br. at 4), and that she "suspected that Beck personnel had made misrepresentations" (*id.* at 10), she asserts that

this knowledge was insufficient to put her on notice either as to the alleged misrepresentation of Beck's financial condition in earlier years (*id.* at 4, 15) or as to Ernst & Ernst's alleged participation in the misrepresentation (*id.* at 4, 10, 12). However, two recent decisions, one by this Court and the second involving another claim against Ernst & Ernst arising out of the Beck bankruptcy, demonstrate that her argument is unsupportable—a point which is confirmed by her own admissions.

### **1. *The Decline and Fall of Beck***

In each of the two recent decisions on point, the court found that knowledge of a company's financial deterioration was sufficient to start the statute running as to the company's independent auditors, where, as here, the auditors had been charged with failure to reflect accurately the company's financial condition.

#### **a. *Berry Petroleum Co. v. Adams & Peck***

In *Berry Petroleum Co. v. Adams & Peck*, 518 F.2d 402 (2d Cir. 1975), this Court affirmed a summary judgment dismissing a Rule 10b-5 action closely analogous to the present one. Plaintiffs had charged that Commonwealth United Corporation ("CUC") had misrepresented its financial condition in connection with various transactions undertaken by it in 1968, including an agreement to buy shares of Seeburg Corporation. 518 F.2d at 410. The court, applying the Texas three-year statute of limitations, found the claims barred as to all defendants, including the independent auditor Arthur Young and Company, "because the fraud on which it is based was known or should have been known to plaintiffs more than three years prior to their commencement of their suit on December 15, 1972." *Id.* at 409-10.



Pointing out that the statute begins to run when plaintiffs should have discovered a general fraudulent scheme, rather than when plaintiffs become aware of all the various aspects of the alleged fraud, Judge Lumbard relied on the following evidence to support his conclusion that the action was time-barred:

"... the American Stock Exchange suspended trading in CUC stock on July 22, 1969, and the Securities and Exchange Commission (SEC) suspended trading in CUC stock in the over-the-counter market on August 1, 1969. On July 22 the complaint indicates that CUC stock was selling for \$8.125 a share. By August 1, it had declined to about \$4.50 a share and in late December it had fallen further to about \$2.50 a share. The *Land* action was commenced in August 1969, other private actions followed, and the SEC obtained a consent order against CUC in October 1969. The SEC action was publicized in financial newspapers. See, e.g., N.Y. Times, Oct. 3, 1969, at 63, col. 4; Wall St.J., Oct. 3, 1969, at 28, col. 2. Much of the fraud alleged here was also alleged in the *Land* case. Since those plaintiffs discovered the fraud, there is no doubt that the fraud was discoverable prior to December 5, 1969.

*In light of the trading suspensions, the precipitous decline in the price of CUC stock, and the other lawsuits by the SEC and private parties, we think that Judge McFadden correctly concluded that plaintiffs with reasonable diligence could and should have discovered the alleged fraud prior to December 15, 1969."* 518 F.2d at 410 (emphasis added).

The factors relied upon by the Court in *Berry Petroleum* are all present in the case at bar. There was a precipitous decline in the price of Beck stock from \$42.50 in February 1969 to \$4.50 in July 1970. Trading in Beck stock was sus-

pended on the American Stock Exchange in July 1970. Other lawsuits, all noted in the public press, were brought by private parties against Beck in 1970 and 1971.

In fact, the evidence of financial disarray is far stronger here than it was in *Berry Petroleum*, where plaintiffs contended (unsuccessfully) that they could not have been expected to know of the alleged fraud until a subsidiary of CUC filed for bankruptcy. 518 F.2d at 410. In the case at bar, two of Beck's subsidiaries filed under Chapter XI of the bankruptcy laws in 1970, and Beck itself filed a Chapter X petition in May 1971.

**b. *Briskin v. Ernst & Ernst***

The court's decision in *Briskin v. Ernst & Ernst*, 398 F. Supp. 997 (C.D. Cal. 1975) (appeal pending), is of special significance to the case at bar. *Briskin* was a Rule 10b-5 action brought by the former shareholders of W & J Sloane of Beverly Hills ("Sloane") against Ernst & Ernst and several members of Beck's management and board of directors. Sloane had been acquired by Beck in September 1969. The complaint, which was filed on June 13, 1973 (398 F. Supp. at 1000) included allegations against Ernst & Ernst which were similar to those made by plaintiff here.\*

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\* The opinion in *Briskin* stated the charges against Ernst & Ernst as follows:

"In their suit against Beck's accountant, Ernst & Ernst, plaintiffs allege that: 'Defendant [Ernst & Ernst] indirectly induced plaintiffs to enter into the transaction aforesaid by means of reckless, careless, unskilled and grossly negligent audit, test, review and verification of said books of account, fiscal records and financial statements, with the result that . . . [the] statements contained untrue statements of material facts, omissions of material facts, deceptive and misleading financial statements representing the net worth of said BECK INDUSTRIES, INC., . . .'" 398 F. Supp. at 1000.

Defendants moved to dismiss on statute of limitations grounds. The issue was whether plaintiffs had been on notice as to defendants' alleged misrepresentations prior to June 13, 1970. The court found as follows:

"We think there are more than sufficient facts present here, when considered in view of the other factors discussed *infra*, to conclude that plaintiffs had ample notice and grounds for reasonably prudent suspicions well before June 13, 1970, that a fraud had been committed upon them by defendants, even when considering all the alleged facts in the light most favorable to plaintiffs." 398 F. Supp. at 1003.

In reaching this conclusion, the court pointed to a number of occurrences that should have put the plaintiffs on notice as to all defendants, including Ernst & Ernst, concerning the alleged misrepresentations. Prior to June 13, 1970, plaintiffs, among other things, had received various documents showing a tremendous increase in short- and long-term debt at Beck; a financial adviser to the plaintiffs had told them that Beck had "alarming debt" and a "bad liquidity problem" (398 F. Supp. at 1004-06); and Beck stock had declined from \$42.50 per share in February 1969 to \$6.00 per share by May 18, 1970.\*

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\* In a leading case in the Seventh Circuit, *Hupp v. Gray*, 500 F.2d 993 (7th Cir. 1974), the Court found in similar circumstances that a great decline in the stock price of the company in question was enough in itself to be indicative of possible fraud, particularly where representations had allegedly been made (as in the present case, *see* 158a-59a) that the stock would go up:

"Even a wholly unsophisticated investor should have realized in March 1967—when the market price had fallen to \$17.50 rather than rising to \$75—the existence of facts sufficient to precipitate into his consciousness a geographical paraphrase of the somewhat

(footnote continued on following page)



If the plaintiffs in *Briskin* were on notice by June 13, 1970 as to alleged misrepresentations concerning Ernst & Ernst, then plaintiff here was assuredly on notice of any similar misrepresentations by April 15, 1972. Between June 13, 1970 and April 15, 1972 a multitude of events occurred which should have cast even further doubts upon any alleged representation as to the soundness of Beck's financial condition: the proposed debenture offering fell through; Beck stock fell to 4½ and trading was suspended on the American Stock Exchange (never to be resumed); there was an entire change in top management; Beck sold a number of subsidiaries that it had acquired in 1969; and the company filed a petition under Chapter X of the bankruptcy laws.\*

### c. Other Relevant Authorities

In *Turner v. Lundquist*, 377 F.2d 44 (9th Cir. 1967), plaintiff claimed that he was fraudulently induced to purchase a \$125,000 convertible debenture of United States Chemical Milling Corporation ("U.S.C.M."). Plaintiff alleged, among other things, the following misrepresentations of fact: that U.S.C.M. was in sound financial condition; that the offered debentures were a sound, secure invest-

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(footnote continued from preceding page)

hackneyed remark of Marcellus to Horatio. The sharp fall in the market price was not a concealed fact but, rather, was clearly and painfully revealed to the plaintiff. 'At the very least, these circumstances should have aroused suspicion or curiosity on the part of plaintiff.' " 500 F.2d at 996-97.

While the defendants in *Hupp* apparently were not auditors, the courts in *Berry, supra*, 518 F.2d at 411, and *Briskin, supra*, 398 F. Supp. at 1005, both cited to *Hupp* in holding that the statute had run as to the defendant auditors.

\* It should be noted that in *Briskin*, as here, Ernst & Ernst denied all the charges against it.

ment; and that U.S.C.M.'s financial statements, which were shown to plaintiff, truly and fairly represented the condition of the business and affairs of U.S.C.M. 377 F.2d at 47.

The Court of Appeals for the Ninth Circuit, in affirming the award of summary judgment to defendant, found numerous facts "sufficient in the view of this Court to have put him on notice and inquiry and commenced the running of the period of limitation as a matter of law." 377 F.2d at 48. The dispositive facts were, in the main, letters to the plaintiff, annual reports and financial statements which showed that U.S.C.M. was in an increasingly precarious financial position. 377 F.2d at 48 n.1.

In *Winkelman v. Blyth & Co., Inc.*, 394 F. Supp. 994 (D. Ore. 1973), *aff'd*, 518 F.2d 530 (9th Cir.), *cert. denied*, 423 U.S. 929 (1975), plaintiffs charged that the defendants had misrepresented the financial and operating condition of Aseco, Inc. in inducing them to purchase Aseco stock. Defendants raised the statute of limitations as a defense. The district court found that a letter sent to the shareholders setting out a number of adverse factors about Aseco contained sufficient information to put a prudent man on notice as to possible securities fraud. 394 F. Supp. at 995-96.

\* \* \* \* \*

Not one of the cases cited above was as clear as the case at bar. The cited cases involved decline in price of the company's stock; the publication of adverse financial information; the suspension of trading in the company's stock; and the institution of lawsuits by similarly situated persons. These factors, individually or in conjunction, have been found to be enough to start the statute running as to diverse groups of defendants including independent auditors. In the case at bar, every one of those factors is present, in addition to Chapter XI petitions by Beck sub-

sidiaries and the Chapter X petition by Beck. The well-publicized decline and fall of the Beck empire would surely have put a prudent person on notice, prior to April 15, 1972, that any alleged representations about Beck's being in "sound financial condition" were to be questioned.

**2. *Mr. Daniels' Statements That He Had Been "Taken"***

In addition to the evidence regarding the financial collapse of Beck, the present record includes unique and striking evidence as to the suspicions harbored by plaintiff and her husband almost five years before this action was begun. Mr. Daniels' knowledge of the financial deterioration of Beck impelled him to tell his wife, in July 1970 and again in May 1971, that he had been "taken" in connection with the sale of Hartogs to Beck. Plaintiff contends in her brief that the "meaning ascribed by Mr. Daniels to the word 'taken' is ambiguous on this record" (Pl. Br. at 5).

A reading of Mrs. Daniels' deposition demonstrates that Mr. Daniels' statement was anything but ambiguous. Mr. Daniels amplified on his use of the word "taken" by asserting that the financial condition of Beck had been misrepresented to him (175a, 179a), and that it "could not have been what the papers had showed [it] to be" (175a). Mrs. Daniels had no doubt as to the meaning of her husband's statement:

"Q. Is that correct, what Mr. Mollen has just said, that Mr. Daniels told you that, at those times that the financial statements were not correct?

A. If he says he was taken, I assume that is what he meant.

Q. That the financial statements, which he received prior to the agreement being signed, were inaccurate?

A. Yes." (187a)



We are aware of no analogous case in which the claimant so directly conceded his belief—prior to the critical date, for statute of limitations purposes—that misrepresentations had been made to him which were identical to those alleged in the complaint.

Nevertheless, plaintiff argues that:

“ . . . knowledge in 1970 and 1971 of Beck’s poor financial condition was [in]sufficient to have put plaintiff and her husband on notice that Beck’s financial condition in 1968 and 1969 was not as represented in the financial statements or reports rendered by Ernst and Ernst” (Pl. Br. at 15).

Plaintiff further argues that suspicion as to misrepresentations made by Beck personnel—which she concededly harbored (Pl. Br. at 10)—provided no basis for suspecting Ernst & Ernst. These arguments cannot be squared with the facts of record:

First, plaintiff overlooks her husband’s acknowledgment that Beck’s financial condition had been misrepresented to him.

Second, plaintiff overlooks the allegation of the complaint (¶ 10) that Beck and Ernst & Ernst made the very same misrepresentations which she and her husband suspected Beck of having made in 1970 and 1971—misrepresentations that Beck was in a sound financial condition. Since Mr. and Mrs. Daniels suspected that Beck’s representations were misleading, they were on notice that identical representations by Ernst & Ernst were suspect.

Third, plaintiff overlooks her testimony as to her own understanding of Mr. Daniels’ remarks—*i.e.*, that the financial statements, which Mr. Daniels had received prior to the agreement being signed, were false (187a).

Fourth, plaintiff overlooks the fact—recognized in the complaint—that the allegedly misleading financial statements, which Ernst & Ernst “aided, abetted and actively participated in, and act[ed] in concert with Beck Industries, Inc.” in preparing, issuing and certifying, were “the financial statements of Beck Industries, Inc.” and “the company’s financial statements” (24a-25a). Since Mr. and Mrs. Daniels suspected that Beck’s financial statements were false, they were on notice that “further inquiry into Ernst & Ernst’s role [in helping prepare those statements] would be prudent” (347a).

In addition, plaintiff’s argument ignores the cases which hold that the statute begins to run when plaintiff should have discovered a general fraudulent scheme (here, the alleged misstatement of Beck’s financial condition) rather than when plaintiff became aware of all aspects of the alleged fraud (here, Ernst & Ernst’s alleged participation as an aider and abettor). *See, e.g., Berry Petroleum Co v. Adams & Peck*, 518 F.2d 402, 410 (2d Cir. 1975).

Finally, plaintiff argues at some length that Beck’s financial difficulties did not put her and her husband on notice as to the alleged fraud, because newspaper articles suggested that Beck’s difficulties might be caused by bad management and adverse economic conditions or “other causes unrelated to Beck’s financial condition previously reported upon by Ernst and Ernst” (Pl. Br. 19-22). This argument ignores the fact that plaintiff “concededly suspected that Beck personnel had made misrepresentations” (Pl. Br. 10). Further, the fact that there may be doubts as to the existence of the alleged fraud—doubts reflected *inter alia* in Ernst & Ernst’s denial of plaintiff’s charges—cannot justify plaintiff’s failure to pursue the matter at the time of Beck’s financial collapse. Acceptance of plaintiff’s argument would

permit the pursuit of stale claims—here, claims based on 1968 and 1969 financial statements—almost without limit.\*

**C. Plaintiff's Asserted Lack of  
Business Sophistication**

Plaintiff attempts to justify her inaction, and that of her husband, on the basis of their asserted lack of business sophistication (Pl. Br. at 16-18). It is true that some courts have considered plaintiff's business sophistication as one of many factors relevant to the court's determining whether plaintiff *should* have suspected that misrepresentations had been made. Plaintiff can point to no authority, however, which suggests that sophistication should be a factor—much less a determinative one—where, as here, plaintiff and her successor in interest admittedly believed that misrepresentations had been made.

Even if plaintiff's sophistication were a factor in this case, there are ample, uncontested facts in the record to support Judge Frankel's finding that Mr. and Mrs. Daniels were not naive investors.

As Judge Frankel stated:

"The court also does not find persuasive plaintiff's argument that she and her husband should not be held to have had constructive notice of the fraudulent scheme for purposes of the statute of limitations because they lacked business acumen and sophistication. Mr. Daniels invested in excess of \$4 million in Beck Industries, and he had on occasion holdings in excess of \$100,000 in the stock market [30a, 46a, 152a, 232a].

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\* As Judge Frankel pointed out, "plaintiff's papers are searched in vain for any material information she even claims to have acquired within the limitations period that was not known (or patently available) to her and/or her husband before then" (346a).



Further, during the course of his business career, Mr. Daniels frequently relied on the advice and assistance of accountants, and was thus no stranger to their role in a business enterprise [24a, 146a\*]. In tending to their business affairs and investments, Mr. and Mrs. Daniels should be held to a standard of prudence commensurate with such business experience and the magnitude of their holdings. Surely a prudent investor with over \$4 million at risk would have acted more diligently in investigating possible fraudulent conduct of which he had ample notice than did either plaintiff or her husband here. Plaintiff is held to the standard of what prudent people in these circumstances would or should have known by a date more than three years prior to bringing this case. The suit fails by that standard." (347a-48a)

## II.

### **The Pendent State-Law Claims Were Properly Dismissed.**

Judge Frankel ruled that:

"[S]ince plaintiff's federal claims have been decided adversely at this preliminary stage in the litigation, the court finds it inappropriate to determine the status of the pendent claims." (348a)

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\* Mr. Daniels also used the services of two major securities brokers—one of which acted as finder in the Beck transaction—in connection with his investments, and he was represented during the negotiations by the long-time lawyer for himself and Hartogs (45a, 142a-44a, 150a-51a, 153a, 155a). After the sale, Mr. Daniels continued to be employed by Hartogs as president until the time of his death in 1973 (46a, 148a). Thus, he was neither uninterested in Beck's progress, nor without access to information or professional advice.

This ruling, which plaintiff does not contest, is amply supported by authority. See, e.g., *United Mineworkers of America v. Gibbs*, 383 U.S. 715, 726 (1966); *Iroquois Industries, Inc. v. Syracuse China Corp.*, 417 F.2d 963, 970-71 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970); *Yanity v. Benware*, 376 F.2d 197, 201 (2d Cir.), *cert. denied*, 389 U.S. 874 (1967); *Gilbert v. Meyer*, 362 F. Supp. 168, 177 (S.D. N.Y. 1973).

A second ground for dismissing the state claims is that they are time-barred by the applicable state statutes of limitation.

All of the state claims, except count five, are framed in either fraud or negligence. If they are considered claims for fraud, the New York borrowing statute will require the application of California's three-year statute of limitations for fraud actions. As demonstrated above, that three-year fraud statute has clearly run on plaintiff in the case at bar.

If some or all of these claims are viewed as negligence claims, they are barred by the negligence statutes of limitation. See, e.g., *Moonie v. Lynch*, 256 Cal. App.2d 361, 64 Cal. Rptr. 55, 58 (1967) (Cal. Code Civ. Proc. § 339(1), 2 years); *Carr v. Lipshie*, 8 A.D.2d 330, 187 N.Y.S.2d 564 (1st Dep't 1959), *aff'd*, 9 N.Y.2d 983, 176 N.E.2d 512, 218 N.Y.S.2d 62 (1961) (N.Y. CPLR § 214, 3 years). Thus, plaintiff's state-law negligence claims in the present case are barred no matter which state's law is applied.

Plaintiff's fifth cause of action purports to be a state claim for breach of contract. However, in cases of alleged professional misconduct, the courts in both California and New York have determined which statute of limitations was applicable by looking to the substance of the transaction rather than the label which plaintiff has attempted to apply. Thus, in actions against professionals for failure to per-

form services in accordance with appropriate standards, the courts have consistently applied the two-year malpractice time limit (California) or the three-year negligence time limit (New York), even where plaintiffs have attempted to invoke the longer period for breach of contract. *See, e.g., Neel v. Magana, Olney, Levy, Cathcart & Gelfand*, 6 Cal.3d 176, 491 P.2d 421, 424, 98 Cal. Rptr. 837, 840 (1971); *Carr v. Lipshie, supra*; *Wilkin v. Dana R. Pickup & Co.*, 74 Misc.2d 1025, 1027, 347 N.Y.S.2d 122, 125 (Sup. Ct. Allegany County 1973).

### CONCLUSION

For the reasons set forth above, Judge Frankel's holding should be affirmed and plaintiff's claims should be dismissed in their entirety, with costs to be awarded to the defendant.

Dated: New York, New York  
May 2, 1977

Respectfully submitted,

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